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BEFORE THE  
SURFACE TRANSPORTATION BOARD

STB EX PARTE NO. 582



PUBLIC VIEWS ON MAJOR RAIL CONSOLIDATIONS

**POST-HEARING COMMENTS OF CP, CSX,  
NORFOLK SOUTHERN AND UNION PACIFIC**

Yesterday afternoon the undersigned railroads<sup>1</sup> learned that Burlington Northern Santa Fe Railway Company ("BNSF") had filed post-hearing comments in this proceeding (the "BNSF Comments").<sup>2</sup> By contacting CN counsel, we also learned that CN had filed additional comments (the "CN Comments"). Neither BNSF nor CN (collectively, "BNSF/CN") served their comments on the many interested parties in this proceeding.

In light of the Board's announced intent to issue an order in this proceeding this week, BNSF's and CN's last-minute comments appear to have been calculated to preclude any response. Most parties are unlikely to receive them in time. Nonetheless, in the very limited

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<sup>1</sup> The railroads are Canadian Pacific Railway Company ("CP"), CSX Corporation and CSX Transportation, Inc. ("CSX"), Norfolk Southern Corporation and Norfolk Southern Railway Company ("Norfolk Southern") and Union Pacific Railroad Company ("Union Pacific").

<sup>2</sup> The BNSF Comments are styled as a reply to a petition for a rulemaking proceeding filed by Edison Mission Energy Company and Midwest Generation, LLC. No such "petition" was filed. In any event, the BNSF comments make clear that they respond to a large number of comments in this proceeding, including the comments and testimony of the undersigned railroads.

time available, the undersigned railroads offer the following comments on only a few aspects of the BNSF/CN arguments.

When the Chief Executive Officers of the undersigned railroads testified during the hearings, they offered differing views on many of the important issues before the Board. All agreed, however, that the public interest would be served if there were a halt, for some significant period of time, to the continuing consolidation of North America's large railroads. Like many other witnesses, and like numerous additional parties who filed written comments, the railroad CEOs noted that a pause would replace the regulatory uncertainty caused by the BNSF/CN merger announcement with a period of calm during which railroad financial markets can recover. It would achieve this result primarily by reducing the demand for debilitating regulation of the industry. And it would allow railroads to continue to focus their efforts on improving service, as so many shippers demand, and not responding to more railroad merger proposals.

As we will explain here, the Board has the legal authority to adopt a cooling off period in rail merger activity. Doing so will bring a period of stability to the industry, encouraging investment, while simultaneously affording the Board time to revise outdated public policies regarding large railroad mergers.

### **Introduction**

In launching this proceeding, the Board announced its intent to address broad and important issues of public policy: "major rail consolidations and the present and future structure of the North American railroad industry." Decision served Jan. 24, 2000, p. 2. BNSF and CN avowedly have a much narrower goal. As CN admits in eschewing those "larger issues," its "concern is that it receive prompt review of the proposed BNSF/CN combination." CN Comments, p. 1. One might have hoped that hearing the drumbeat of concerns about the adverse

effects of rail consolidations on numerous constituencies, including a call from their largest shippers -- customers such as United Parcel Service and General Motors -- for a rejection of all additional mergers among large railroads, would have caused BNSF and CN to look at the larger issues and change their plans. But that was not to be. As both BNSF and CN have now made clear, their objective is to force the Board and all stakeholders in the rail industry to undertake a year-long investigation of a BNSF/CN consolidation.

**A. BNSF/CN's Characterization of the Record**

A principal function of the BNSF/CN comments appears to be to tell the Board what it read and saw during this proceeding. We doubt that the Board needs that assistance, and we will not presume to provide it. We would note only that BNSF and CN appear to have witnessed a different hearing than others.

BNSF contends that "There Is No Consensus in Favor of a Moratorium on Future Combinations." BNSF Comments, p. 5. CN argues that the hearings were primarily about service, which participants want to address on a case-by-case basis. CN Comments, pp. 1-2. Objective observers gained a different perspective:

- "The vast majority of shippers, government organizations, and major railroads other than BN and CN asked the STB to exert their ability to call for a pause before moving forward on any additional rail mergers." Jill Evans, J.P. Morgan, "Potential Outcomes from STB Hearings on Railroad Consolidations," March 13, 2000 (Exhibit A).
- "[P]olitical and shipper elements . . . , overwhelmingly, decried further railroad industry consolidation in these four days of hear-

ings.” James M. Higgins, DLJ Securities, “Tracking the Rails: Awaiting Word From the STB,” March 14, 2000 (Exhibit B).

- “The overall sentiment at these hearings was, in our opinion, decidedly negative (*i.e.* against future mergers without a moratorium or further regulation).” Douglas W. Rockel, ING Bearings, “The Outcome of STB Hearing Could Act as an Industry Catalyst,” March 14, 2000 (Exhibit C).

BNSF takes comfort in its claim that “far fewer than half of all commenters during the hearings” supported a moratorium. BNSF Comments, p. 2. But the Board did not solicit comments on a moratorium, an idea that gained credence as the hearing progressed. Shippers and shipper organizations called for a moratorium in a spontaneous uprising against big rail mergers at this time. In addition, large numbers of shippers and shipper organizations -- undoubtedly excluded from BNSF’s count -- are willing to allow more mergers only if the rail industry is subjected to new legislation that BNSF and CN themselves attack as unacceptable. Without such legislation, those shippers oppose large mergers, as the Board’s questioning confirmed.

**B. Investment in the Railroad Industry and Financial Stability**

BNSF and CN insist that a moratorium would deter investment in railroads, while their merger proceeding would encourage it. BNSF Comments, pp. 5-6, 10-12; CN Comments, pp. 20-22. In support of these claims, they rely primarily on witnesses with direct financial ties to BNSF and CN. Both of the investment bankers who testified at the hearings are involved in the BNSF/CN merger, and their firms stand to gain millions of dollars if it is approved. The economists on whom BNSF and CN rely were, as the Board’s questions confirmed, retained and paid by those railroads.

Rather than prolonging debate over the intellectual fine points of investment theory, we respectfully urge the Board to listen to unbiased observers from the financial community who have spoken to investors since the hearings began. They conclude that investors, including BNSF and CN investors, would applaud a delay in the rush toward mergers:

- According to Jill Evans of J. P. Morgan, “a mid-term (sixth-month-two-year) moratorium on rail mergers” would be the most beneficial possible outcome of the Board’s hearings. Jill Evans, J. P. Morgan “Potential Outcomes from STB Hearings on Railroad Consolidations,” March 13, 2000 (Exhibit A). According to Ms. Evans, this would be the preferred outcome for investment:

“This would provide near term stability for shippers but still long term merger synergies for the rail carriers. Stock reaction: Best case scenario for rail stocks -- would expect some multiple expansion. . . . We believe this is the best case scenario for rail stocks since it will push out the timeframe for additional rail mergers which will appease shippers but will also allow the opportunity for future consolidation and growth for the rail carriers.

. . .

We believe this outcome offers the least threat of negative rail regulation and is actually what most industry analysts were expecting prior to the BN / CN merger announcement in December that triggered the need for four days of STB hearings on the future of the rail industry. We believe the rail stocks would have a positive reaction.

. . .

As Ms. Evans explains, one of the principal advantages of a moratorium would be to cause BN and CN to “cancel their merger, but very likely form an alliance to look for revenue

and cost synergies without a merger. This would be positive for BN and CN shareholders since we assume that some benefits of an alliance would create additional earnings growth.”

- The day after he testified before the Board, Morgan Stanley-

Dean Witter’s James J. Valentine told investors:

“We believe the STB’s decision will likely contain some delay to the merger game. In the short-term, such a decision is likely to be viewed positively by the market as it would pre-empt what we believe is otherwise an imminent, final round of rail consolidation this spring.”

James J. Valentine, Morgan Stanley\D.W., “STB Delay Could Give a Slight Boost to Stocks,” March 8, 2000 (Exhibit D). Mr. Valentine opined that BNSF and CN stocks would “enjoy some near-term strength” from a delay to the merger process.

- Analyst Douglas W. Rockel of ING Bearings reached the same conclusion:

“Consequently we believe the STB will either impose a moratorium on the [BNSF/CN] merger or place further regulations on future mergers. Any such action could act as a catalyst for future rail stocks, which have been out of favor with investors,”

Douglas W. Rockel, ING Bearings, “The Outcome of STB Hearing Could Act as an Industry Catalyst,” March 14, 2000 (Exhibit C).

- Although James M. Higgins of DLJ Securities questions whether the Board has the legal authority to impose an outright ban on future mergers, an issue we address below, he noted that “there is more than one way to skin the proverbial cat.” His analysis con-

firms that the resulting delay would improve investment conditions and benefit stockholders:

“We believe the STB’s direction in handling the BNI/CNI case will help bring some stability to financial market views of the railroads -- although we cannot at this point predict exactly how they get there. If that happens, we believe railroad stocks may begin to trade more on their fundamentals and, pretty much regardless of the company, that looks to us likely to produce somewhat higher prices.”

As Mr. Higgins explains, investors need to see how the Board reaches this result before they can get “too optimistic about a complete elimination of rail mergers from the investor frame of view.” Nevertheless, he expressed confidence and believes that “the STB is aware” of the need to “correct the discount for perceived regulatory risks the market has built into the stocks.” James M. Higgins, DLJ Securities, “Tracking the Rails: Awaiting Word From the STB,” March 14, 2000 (Exhibit B).

Unlike the financially interested BNSF and CN witnesses, these investment analysts have only one bias: a bias in favor of increased stability and greater investment in the railroad industry. Unlike the abstract and theoretical positions of BNSF and CN witnesses, these analysts offer a simple and straightforward observation: If the Board halts mergers now, investors will be more willing to invest in the railroad industry and will bid up its stock prices.

### **C. The Board’s Legal Authority to Impose a Moratorium**

There was voluminous testimony presented during the recent hearing that no major rail consolidation transaction would be in the public interest at this time. There was also tes-

timony that, at the very least, the Board's existing rail merger policies and procedures require reconsideration and amendment before another rail consolidation proposal could be properly evaluated. Were the Board to agree on either point, a temporary moratorium or suspension of consideration of major rail consolidation proposals would be warranted. Contrary to the suggestions made by BNSF and CN, the Board has ample authority to take such remedial action if (as the undersigned railroads believe) it is warranted by the evidentiary record developed in this proceeding.

**1. The Board Has Authority to Suspend Consideration of Further Rail Consolidation Proposals Pending Review and Revision of its Merger Policies and Procedures.**

As previously noted, many witnesses during the recent hearing in Ex Parte 582 (including certain of the undersigned railroads) urged the Board to commence a proceeding to reconsider, update and revise its Railroad Consolidation Procedures. It could initiate such a rulemaking proceeding to reconsider broad rail merger policy and, in doing so, it could lawfully suspend consideration of any new major rail consolidation application pending the completion of such rulemaking.

Courts have frequently sustained similar agency orders to suspend consideration of individual applications pending adoption or revision of governing standards or procedures. *See, e.g., Westinghouse Electric Corp. v. NRC*, 598 F.2d 759 (3d Cir. 1979) (and cases cited therein); *Kessler v. FCC*, 326 F.2d 673 (D.C. Cir. 1963); *Albrechtsen v. Andrus*, 570 F.2d 906 (10th Cir. 1978); *Krueger v. Morton*, 5923 F.2d 235 (D.C. Cir. 1976). As these cases held, such a temporary suspension of consideration of individual cases does not unlawfully deprive a party of any due process or statutory right to a hearing on contested issues. The reliance by BNSF and



CN on the statutory deadlines for handling an application after its filing and acceptance is therefore misplaced.

BNSF and CN nonetheless claim that adoption of such a temporary freeze on the consideration or processing of a rail consolidation application would violate the statutory provisions establishing specified timetables for procedural consideration of an application. This claim is without merit for the reasons discussed below. The statute plainly states that the Board “may” initiate a proceeding upon the filing of a rail consolidation application. 49 U.S.C. § 11324(a). This permissive language cannot be construed to impose a mandatory obligation on the Board to consider and process an application when it is in the process of reconsidering the very standards and procedures under which it will be governed. Moreover, an application filed before the conclusion of such a rulemaking proceeding would obviously be subject to rejection as incomplete, as both the statute and existing regulations contemplate. Accordingly, the Board would be well within its broad authority to suspend consideration of any major rail consolidation application pending review of its rail merger policies.

**2. Alterantively, the Board Can Find Now That No Class I Merger Is In The Public Interest.**

If the Board were to conclude – based on the record here, as well as its extensive experience with past Class I mergers and the Board’s considerable general expertise in rail matters – that additional Class I mergers are not consistent with the public interest at this time, it plainly would have the authority to do so, without commencing a new rulemaking proceeding to consider revisions to existing policies and procedures. CN and BNSF do not appear to question the Board’s authority to reach this policy conclusion, although they certainly contend that the judgment would be unwarranted. Rather, their position appears to be that, even if the Board finds that Class I mergers are inconsistent with the public interest, the Board would nevertheless

be compelled to accept a CN/BNSF application and embark on a year-long proceeding to review the “merits” of the specific combination that these applicants intend to propose.

This narrow view of the Board’s authority is simply incorrect. This Board – like other administrative agencies – has the authority to adopt rules that substitute a general judgment regarding matters falling within its jurisdiction for ad hoc, case-by-case resolution. Congress expressly gave the Board broad authority to “prescribe regulations in carrying out this chapter and subtitle IV.” See 49 U.S.C. § 721 (which encompasses the provisions of the ICCTA governing rail combinations, i.e., 49 U.S.C., §§ 11321-28). Congress also stated that “[e]numeration of a power of the Board in this chapter or subtitle IV does not exclude another power the Board may have in carrying out this chapter or subtitle IV.” Id. Applying this provision, the U.S. Supreme Court has held that this broad rulemaking authority gives the agency discretion to prescribe substantive rules and fashion remedial requirements even when not expressly authorized by statute. See, e.g., Interstate Commerce Commission v. American Trucking Associations, Inc., 467 U.S. 354 (1984); Trans Alaska Pipeline Rate Cases, 436 U.S. 631 (1978); American Trucking Associations, Inc. v. United States, 344 U.S. 298 (1953); see also American Commercial Lines, Inc. v. Louisville & Nashville R.R., 392 U.S. 571, 592 (1968) (ICC entitled to “reasonable latitude to decide where it will resolve these complex issues, in addition to how it will resolve them.”); UTU v. ICC, 52 F.3d 1074, 1079 n.10 (D.C. Cir. 1995) (upholding ICC’s inherent general authority to “carry out” the provision of the Interstate Commerce Act”).<sup>3</sup> The Board’s

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<sup>3</sup> This authority is a complete answer to CN’s suggestion that the public interest test under ICCTA has a “very specific and limited *procedural* context, governing only the Board’s approval of a transaction in a proceeding already begun upon application by a person seeking control authority” (CN Comments, p. 28 (emphasis in original)) and that there exists no “other authority (continued...)”

statutory authority is of course at its zenith with respect to rail combinations. Congress has expressly made that authority “exclusive,” 49 U.S.C. § 11321(a), and provided that no Class I combination may be carried out without the approval of the Board upon an affirmative finding that the transaction is “consistent with the public interest.” 49 U.S.C. § 11324(c).

The courts have repeatedly upheld agency rules that embody policy judgments affecting classes of cases that supplant individualized, case-by-case adjudication. See generally, e.g., Heckler v. Campbell, 461 U.S. 458 (1983); United States v. Storer Broadcasting, 351 U.S. 192 (1956); Shippers Committee, OT-5 v. ICC, 968 F.2d 75, (D.C. Cir. 1992) (“[c]hoice made between proceeding by general rule or an individual, ad hoc litigation is one that lies primarily in the informed discretion of the administrative agency”) (quoting SEC v. Chenery, 332 U.S. 194, 203 (1947)); Association of Oil Pipe Lines v. FERC, 83 F.3d 1424 (D.C. Cir. 1996) (upholding FERC’s construction of “full hearing” requirement satisfied by notice and comment rulemaking); Telocator Network v. FCC, 691 F.2d 525, 551 (D.C. Cir. 1982) (recognizing that Commission appropriately employs its rulemaking power when issues “involve legislative rather than adjudicative facts, and have prospective effect and classwide applicability.” (Footnotes omitted)); American Trucking Associations, Inc. v. United States, 642 F.2d 916 (5th Cir. 1981) (sustaining ICC regulation that prescribed content of “public convenience and necessity” for motor carrier operating licenses and thereby precluded certain issues from being contested in individual licensing proceedings; Chemical Leaman Tank Lines, Inc. v. United States, 368 F. Supp. 925 (D. Del. 1973) (same).

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for the Board to adopt rules or regulations or to preclude such applications from being filed.” Id., pp. 28-29.

For example, in Committee for Effective Cellular Rates v. FCC, 53 F.3d 1309 (D.C. Cir. 1995), the court held that the FCC acted within its discretion when it made a general “policy decision” to adopt revised technical specifications for all cellular licenses that had the effect of modifying existing licenses. The court held:

It is because the Commission has this authority -- to establish rules of general applicability, such as the technical requirements of licenses -- that the Committee’s argument that the Commission should have conducted individual adjudications under sections 308 and 309 before modifying existing cellular licenses fails. Those provisions govern a licensee’s request for modification of a particular license. They do not deprive the Commission of its authority to pursue a rulemaking ‘necessary for the orderly conduct of its business.’

Id., 53 F.3d at 1320 (citing Storer Broadcasting, 351 U.S. at 202-03).

In reaching this conclusion, the court relied upon WBEN, Inc. v. United States, 396 F.2d 601, 617-18 (2nd Cir.), cert. denied, 393 U.S. 914 (1968), in which the Second Circuit held that the FCC “need not engage in evidentiary hearings required for modification of a particular license, because “when . . . a new policy is based upon the general characteristics of an industry, rational decision is not furthered by requiring the agency to lose itself in an excursion into detail that too often obscures fundamental issues rather than clarifies them.” 53 F.3d at 1319 (quoting WBEN, 396 F.2d at 618). Similarly, in American Airlines Inc. v. CAB, 359 F.2d 624, 625-26 (D.C. Cir.), cert. denied, 385 U.S. 843 (1966), the court rejected a challenge to a rule-making proceeding and held that the Board’s rulemaking authority “is not to be shackled ... by importation of formalities developed for the adjudicatory process and basically unsuited for policy rule making.” Id. at 629. See also Chemical Leaman Tank Lines, 368 F. Supp. at 935 (D. Del. 1973) (“[T]he Supreme Court has sustained an agency’s power to employ rulemaking for the purpose of declaring general licensing criteria, even though those criteria will influence, and perhaps summarily decide, the fate of later licensing applications.”) (emphasis added).

Even if the Board were required, in adopting a new rule finding Class I rail mergers to be contrary to the public interest at this time, to proceed by way of notice and comment rulemaking, on the current record the Board would have “good cause” to make its rule effective immediately with the notice and comment period to follow. Administrative Procedures Act, 5 U.S.C. § 553(b)(3)(B). This is a frequently used procedure. See, e.g., Health and Human Services Interim Final Rule, Individual Development Accounts, 65 Fed. Reg. 10,027 (2000); EPA Interim Final Rule, Asbestos Model Accreditation Plan, 59 Fed. Reg. 5236 (1994); Interim Rule With Request For Public Comments, Regulation Y, 12 C.F.R. § 225 (2000). There is ample support in the record for a rule establishing an immediate moratorium to foster regulatory certainty and stability in the industry, and given that the likely commenters on any such rule would be the same parties that participated in the Ex Parte 582 hearing, there certainly is good cause to issue a rule now based on the record in that proceeding, subject to the possibility that the rule could be pulled back following an additional period of public comment. Alternatively, the Board may use 49 U.S.C. § 721(b)(4), which authorizes the Board to adopt rules without notice-and-comment procedures when necessary to prevent irreparable harm.

Moreover, not only would a rule announcing the Board’s general policy determination regarding Class I mergers be within the Board’s authority, the Board has a virtual obligation to reconsider its outmoded rail consolidation rules and the policy judgments it has made on an ad hoc basis in recent merger cases. See, e.g., Independent Bankers Ass’n v. Farm Credit Admin., 164 F.3d 661, 668 (D.C. Cir. 1999) (agency must consider “the wisdom of its policy on an continuing basis”). In Bechtel v. FCC, 957 F.2d 873 (D.C. Cir. 1992), for example, when the FCC applied a 1965 policy statement to award a license to an applicant based on the applicant’s intention to integrate ownership and management, the court of appeals remanded based on evi-

dence that the regulation had not achieved its desired objective. The court held that the agency had a “duty to evaluate its policies over time to ascertain whether they work – that is, whether they actually produce the benefits the Commission originally predicted they would.” 957 F.2d at 881. A fortiori the Board has a right to reexamine whether its merger policies are appropriate and apply new policies to pending and future applications.<sup>4</sup>

If despite the Board’s issuance of a rule announcing its policy judgment that mergers were not in the public interest at this time, an application were nevertheless filed, the Board would not be required by statute to ignore its policy judgment and conduct a year-long proceeding to review the application. Under Section 11324, the Board “*may* begin a proceeding.” (Emphasis added.) Under Section 11325(a), the Board is free to reject any application that it determines to be incomplete. The Board has long had regulations – which CN and BNSF do not challenge – establishing that one of the requirements of any application is a *prima facie* case supporting approval. 49 C.F.R. § 1180.4(c)(8). If the Board has already made a policy judgment that no Class I combination is consistent with the public interest under a given set of industry circumstances, an application obviously would not make out the *prima facie* case required by existing regulations. There would be no point – and certainly no statutory requirement – to accept an application and go through the motions or the “excursion into detail” of a year-plus proceeding. Likewise, the Board had intrinsic authority to dismiss an application once filed and ac-

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<sup>4</sup> BNSF’s contention (BNSF Comments at 15) that the Board’s policy is to encourage mergers ignores that the policy only applies to those transactions that are “in the public interest.” A moratorium based on a conclusion that such transactions were not in the public interest would not violate these policies. Indeed, it is manifestly clear that the Board’s 1980 policy statements that express a policy favoring consolidations are woefully out of date, given that there is no longer any need to rationalize an over-built rail system.

cepted when the facts -- or the Board's generalized policy judgment -- establish that the transaction cannot satisfy the public interest test.<sup>5</sup> Indeed, a "moratorium" would provide precisely what BNSF and CN say the statute commands: an "expeditious handling and resolution" of their application. CN Comments, at 26.

The one case cited by CN (CN Comments at 26) – Forest Guardians v. Babbitt, 174 F.3d 1178, 1190 (10th Cir. 1999) – is not to the contrary. In that case, the agency was under statutory mandate to designate a habitat for the silvery minnow and, despite many years of delay, had failed to do so. A Board rule establishing a "moratorium" would not contravene any similar statutory mandate. Here, if the Board concludes that a form of moratorium is supported and issues a rule, it can then dispose of any applications on the merits by declining to accept them (or dismissing them if already filed) for failure to satisfy the public interest standard, which is well within the Board's discretion.<sup>6</sup>

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<sup>5</sup> This is a complete answer to CN's assertion that Congress "provided no discretion for the Board either to shut its doors and prevent the filing of rail control applications or to decline to review or disposition [sic] of such an application, once filed." CN Comments, p. 25.

<sup>6</sup> The Board's ability to reject or dismiss an application makes clear that the statutory procedural deadlines do not limit the Board's authority to reach a determination that no mergers are in the public interest. CN acknowledges that these deadlines come into play only if the Board chooses – in its discretion – to accept an application as complete. CN Comments, p. 26 & n.15; p. 27.

It is also clear that those deadlines are not mandatory. Absent penalties for failure to abide by those deadlines, they would be regarded as merely "directory." E.g., BRC v. Pena, 64 F.3d 702, 704 (D.C. Cir. 1996) (absent specification of consequences if not met, statutory period within which "petition shall be decided" is "directory rather than mandatory"); Gottlieb v. Pena, 41 F.3d 730 (D.C. Cir. 1994) (same); Action on Smoking & Health v. Department of Labor, 100 F.3d 991, 993 (D.C. Cir. 1996) (statute and regulation providing agency "shall" issue a rule within designated time is "aspirational only").  
(continued...)

CN and BNSF's suggestion that there may be "retroactivity" problems with any change by the Board in the requirements for an application to be accepted as complete is without merit. First, it has long been a requirement that any application set forth a prima facie case, which would not be present if the Board had reached a determination that no Class I mergers were in the public interest at this time.

Second, there is no merit to the contention that the Board would be constrained in dealing with a CN/BNSF transaction under new rules of general application to Class I combinations by virtue of the applicants having acted in "reliance" on existing standards. An agency action is not impermissibly retroactive even if it "renders valueless an application filed in reliance on a prior rule." Bergerco Canada v. U.S. Treasury Dept., 129 F.3d 189 (D.C. Cir. 1997). In Bergerco, the court rejected a challenge to agency action where Bergerco applied for a license to allow it to collect payment on a debt from frozen Iraqi assets under a set of rules that gave it a "very good chance" of securing the license, and the licensing agency (the Office of Foreign Assets Control) "then changed the rules, so that Bergerco had no chance whatever." The Court held:

"There is one sense, of course, in which Bergerco did have a right as of August 15 to have its license application processed under the criteria in force at the time: If OFAC had acted on Bergerco's application the day it was filed (August 21) and denied the license,

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Moreover, CN's counsel has argued precisely the opposite of the position CN now asserts regarding the mandatory nature of the Board's deadlines for control proceedings. In the UP/CNW Control proceeding, SP sought to delay the proceeding to allow consideration of other announced rail mergers. On behalf of SP, Mr. Cunningham (CN's lawyer here) argued that the Commission had authority to ignore its statutory deadlines in service of the public interest, for years if necessary, and simply report to Congress that it had violated them. ICC Finance Docket No. 32133, Union Pacific Corp., et al. – Control – Chicago & North Western Transportation Co., et al., SP Petition for Stay of Oral Argument (SP-49), Oct. 28, 1994, p. 12 n.11.



Bergerco could have obtained judicial relief if OFAC had departed from the then-applicable rules, and could have obtained at least a remand for the exercise of OFAC's discretion in accordance with those criteria. But if the expectation enjoyed by Bergerco on the basis of this basic rule-of-law concept qualified as a "right" for purposes of determining impermissible retroactivity, then virtually every licensing applicant would acquire protection from any rule-made variation in licensing standards, even where the original set of rules was vague or obviously provisional. We have rejected any such broad view of applicants' rights."

See also DIRECTV, Inc. v. FCC, 110 F.3d 816, 826 (D.C. Cir. 1997) (rejecting challenge to FCC decision to put up for competitive bidding certain DBS channels that the Commission had previously said would be distributed pro rata among certain preexisting permittees; previous order did not give petitioners the right to any specific channel but merely set out the FCC's plan for the distribution of reclaimed channels, and the agency was free to change the rules for such distribution so long as new rules were not arbitrary and capricious).

Likening a Board moratorium to a "cartel," CN argues a moratorium would be "anti-competitive." CN Comments, p. 23. CN asserts that the undersigned railroads "would not be here" were it not for their "protectionist" motives. Id. at 24. Both CN and the expert it quotes ignore our overriding concern that the BNSF/CN merger proposal may subject the railroad industry to crippling re-regulation, a concern that is destabilizing our stocks and could lead to financial disaster for the entire industry, including BNSF.

In arguing that a merger delay is anti-competitive, CN makes an enormous but unwarranted leap. It assumes that its merger would be found to be in the public interest, and also that it would be found to be pro-competitive. No doubt that is CN's view of its own proposal, but the consensus at the hearings was that no Class I merger is now in the public interest. Many shippers object to additional mergers as anti-competitive. CN's advocacy regarding its own

merger is not equivalent to a loss of competition. If the Board finds that further mergers are not in the public interest, no prospective competition is lost.

Contrary to CN's assumption, national transportation policy does not require the Board to grant every allegedly pro-competitive application in order to "ensure effective competition." 49 U.S.C. § 10101(5). The Board must balance numerous elements of transportation policy, and it has ample discretion in performing that task. Union Pacific R.R. v. STB, 202 F.3d 337 (D.C. Cir. 2000). Among other concerns, it must "ensure the development and continuation of a sound transportation system" (49 U.S.C. § 10101(3)), a goal not advanced by the current instability in the financial markets. It also must "minimize the need for Federal regulatory control over the rail transportation system." 49 U.S.C. § 10101(2). The undersigned railroads believe that additional Class I merger proposals will move the nation in precisely the opposite direction.

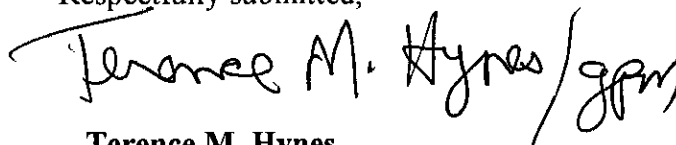
CN argues that the Board erred when it included within the scope of this proceeding possible changes in federal regulation. In light of the express national policy requiring the Board to minimize the need for regulation, this argument is obviously wrong. In applying its transportation expertise, the Board is not limited to making recommendations to Congress. It is required by law to administer its statute to avoid the need for more regulation. In addition, the Board can and should consider that the mere risk of re-regulation is itself destabilizing the industry today, a problem that will remain if merger proposals advance..

Accordingly, the Board has full authority, should it wish to exercise it, to adopt and make immediately effective a new substantive rule declaring that no major rail consolidation transaction would be in the public interest at this time and for a specified period of time.

**Conclusion**

For all of the foregoing reasons, the Board has the necessary legal authority to take appropriate remedial action in response to the testimony adduced during the recent hearings, and should exercise this authority promptly.

Respectfully submitted,

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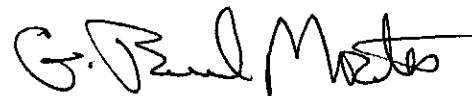
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DATED: March 15, 2000

**CERTIFICATE OF SERVICE**

I hereby certify that, on this 15th day of March, 2000, I served the foregoing  
“Post-Hearing Comments of CP, CSX, Norfolk Southern and Union Pacific” by first-class mail,  
postage prepaid, to each of the following:

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09:06am EST 13-Mar-00 J.P. Morgan (EVANS, JILL (1-212) 648-9422) BNI CNI CSX NS  
RAILROAD INDUSTRY: POTENTIAL OUTCOMES FROM STB HEARINGS ON CONSOLIDATIONS

March 13, 2000

J.P. MORGAN SECURITIES INC. - EQUITY RESEARCH

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Railroad Industry

#### POTENTIAL OUTCOMES FROM STB HEARINGS ON RAILROAD CONSOLIDATIONS

The Surface Transportation Board (STB) concluded four days of hearings from March 7th-10th regarding railroad consolidation and the impact on the present and future structure of the North American railroad industry (see below for background details). The STB is expected to announce some course of action regarding the future of rail consolidation as early as this week. The most important decision is whether or not the STB will accept the merger application of Burlington Northern (BNI/\$19 11/16/Buy) and Canadian National (CNI/\$24 1/8/Buy) which is expected to be filed on March 20th or will the Board call for a moratorium of some length on further rail mergers until more stringent criteria can be established. We believe there is tremendous pressure on the STB to provide some concessions to the shipping community based on the perceived failure of the recent round of rail consolidation and the growing call from members of Congress to "proceed cautiously" in reviewing future mergers. We therefore believe that the STB will enact some short- to mid-term moratorium (up to 2 years) before accepting the BN / CN merger application. The goal will be to allow industry-wide service levels to improve while working with the railroads and shippers to encourage long term private sector market solutions to the difficult issue of balancing future rail consolidation with the need for additional competition. We believe the rail stocks would react positively to this scenario since this would provide near term stability for shippers but still long term merger synergies for the rail carriers. We will certainly need to evaluate our stock ratings after any STB decisions. For now, we are maintaining our BUY ratings on BNI, Union Pacific (UNP/\$35 1/6) and CNI based on their attractive valuations relative to future earnings growth. We also maintain our cautious ratings on the eastern rails (NSC (NSC/\$13 3/16/Long-Term Buy) and CSX (CSX/\$22 1/4/Market Performer)) due to limited near-term earnings visibility.

#### Potential Outcomes:

We expect that the STB will announce that future rail mergers will be scrutinized on some broader service and financial criteria than in the past. The real question then is the timing of when additional criteria measures will be implemented. We believe the question of timing comes down to the following: does the STB accept the BN / CN merger application without delay while assessing potential merger criteria in the future, or does the STB implement some moratorium (a few months or up to five years) on accepting additional merger applications until the industry stabilizes and more data can be analyzed on the potential of additional consolidation. Based on this premise, we have listed what we believe to be four potential regulatory outcomes in order of probability and our prediction on how the rails stocks will react to any verdict.

Outcome #1: A mid-term (6 month - 2 year) moratorium on rail mergers. This would provide near term stability for shippers but still long term merger synergies for the rail carriers. Stock reaction: Best case scenario for rail stocks - would expect some multiple expansion. The vast majority of shippers, government organizations, and major railroads other than BN and CN asked the STB to exert their ability to call for a pause before moving forward on any additional rail mergers. We believe this is the best case scenario for rail stocks since it will push out the

timeframe for additional rail mergers which will appease shippers but will also allow the opportunity for future consolidation and growth for the rail carriers. We believe this outcome offers the least threat of negative rail regulation and is actually what most industry analysts were expecting prior to the BN / CN merger announcement in December that triggered the need for four days of STB hearings on the future of the rail industry.

We believe the rails stocks would have a positive reaction to the following:

- A) The elimination of the risk of additional disruptive rail mergers and less potential for anti-rail regulation in the short term.
- B) BN and CN would cancel their merger, but likely form an alliance to look for revenue and cost synergies without a merger. This would be positive for BN and CN shareholders since we assume that some benefits of an alliance would create additional earnings growth. In addition, both rails are poised to generate significant free cash flow that can be used to buy back shares.
- C) The moratorium would appease many shippers and communities that have been severely impacted by the service problems that have resulted from the past five years of rail consolidation. These groups want the rails to first make good on service benefits promised in the previous mergers before undertaking additional consolidation.
- D) We would assume that the STB would stipulate that the moratorium be used to assess the need for additional criteria for future rail mergers. The STB would likely insist that the rail carriers and various shipper groups come up with compromise measures that would allow for the potential for additional rail consolidation but with additional competitive access. We believe the best case scenario would be private sector solutions that the rails could control (like the recent cram down compromises reached with some labor unions) versus the potential for angry shippers calling for Congressional re-regulation.

Outcome #2: A short-term (less than 6 months) delay in accepting the BN / CN merger application in order to create more stringent service and financial criteria. Stock reaction: Could be mixed, but we believe there is more upside than downside. This scenario could be viewed positively for rail stocks under the assumption that the BN / CN merger would not trigger additional near term consolidation because the other major rails would likely not meet more stringent criteria. In addition, shippers will likely see some concessions on service guarantees and competitive access that may not be detrimental to the railroads. However, this could also be viewed as not going far enough to appease angry shippers and may not eliminate the near term fear of anti-rail regulation. Supporters that urged the STB not to delay in reviewing the merits of the BN / CN merger included a variety of economists, and some of the shippers and local communities (such as Buffalo, NY and Jackson, Mississippi) that would benefit for the combination. In addition, the Department of Transportation and several other shippers stated that they are not opposed to more mergers now, as long as "the bar is raised" or additional criteria is considered, such as sustained service levels and additional competition. For example, the DOT and BN / CN suggested the following additional criteria for future rail mergers, which we believe would support the current BN / CN merger, yet preclude the other rails from prematurely entering into a merger agreements: 1) The applicants' current service and safety records; 2) The financial stability of the applicant / ability to generate cash and invest in infrastructure; 3) Success of past consolidation efforts / examination of previous problems and how to avoid them in the future; 4) Service guarantees in the future, including keeping gateways open, or else pay for trucks or allow other rail competition.

Outcome #3: No delay in accepting the BN / CN merger application with the STB reviewing the stand-alone merits of the proposed combination in addition to simultaneously gathering additional data for future more stringent criteria. Stock reaction: Likely to be negative as this may drive some shippers to call for more immediate rail re-regulation and may prompt more immediate reaction from the other major rails. The STB

has been very hesitant in the past to interfere with market forces which would argue for the acceptance of the BN / CN merger application on its own merits and in a timely fashion. However, we do not know how the STB can incorporate all the suggestions and potential ramifications expressed in the four days of hearings within the next few days. In addition, if there were any changes in future merger criteria, then BN and CN would need time to analyze these impacts prior to filing a merger application. Based on this scenario, we think it will be difficult for BN and CN to submit their formal merger application on March 20th.

Outcome #4: Long-term (2 to 5 year) moratorium on rail consolidation. Stock reaction: Mixed. Some may view this as a positive period of stability for the rail sector, with an extended period of time to focus on service improvements and to study where the industry should be headed. However, we would view this long-term uncertainty about the potential for additional merger synergies as negative. We believe it would be more difficult for the rails to make long term capital decisions under this scenario.

Background on STB Rail Consolidation Hearings, March 7-10:

The unprecedented hearings were triggered by the announcement in December that BNSF and CN signed a merger agreement and intended on filing a merger application with the STB in March. This union would create the largest railroad in North America, accounting for approximately 40% of total industry revenue, which would likely result in competitive responses from the remaining 6 major railroads in the U.S. and Canada and result in further industry consolidation. This scenario prompted outcry from a variety of shippers, government organizations, and even the other major railroads. The majority opinion is that the industry is not ready for another round of consolidation since it is still recovering from the service disruptions caused by the previous two mega-mergers (Union Pacific / Southern Pacific in 1997 and the break-up of Conrail by CSX and Norfolk Southern in 1999). Therefore, the STB went beyond its previous one-at-a-time merger review process and said it will look at the "cumulative impacts and crossover effects" of additional rail consolidation and invited interested parties to submit evidence. The result was four days of hearings with testimony from over 150 participants (see our electronic noted dated March 7th for a complete listing of presenters).

The overwhelming theme at the hearings was the significant decline in rail service and the cost that has been incurred by shippers and communities during the past five years of industry consolidation. Most of the testimony was based on the pain and suffering caused by the Union Pacific / Southern Pacific service meltdown in 1998 and the continuing disruptions with the breakup of Conrail by CSX and Norfolk Southern that began in July of 1999. Unfortunately for BN and CN, they are generally being punished for the mistakes of their peers. The majority of presenters see the merits of the proposed BN / CN merger, acknowledge that the two rails currently have superior service levels, and admit that BN and CN have had better success than their peers with their previous mergers (the BN merged with Santa Fe in 1995 and CN with Illinois Central in 1999). However, the overriding sentiment was that the recent round of rail mega-mergers have been a failure for shippers, who have suffered a decline in service and generally higher rates and costs, and for the railroads who have suffered a decline in operating performance and equity market value. Our experience with previous STB hearings regarding mergers and the UNP service meltdown is that the STB has given the benefit of the doubt to the rails and not offered much compensation to shippers. The difference now is that stakes are much higher. This is because there has been another perceived short term failure with the eastern rail break up of Conrail and the fear that the next round of consolidation will lead to the remaining six major rails merging into only two major transcontinental, North American railroads.

(J.P. Morgan Securities Inc. acted as co- or lead-manager in an offering of securities for BNSF, NSC, and UNP within the past three years. A director of J.P. Morgan is a director of UNP.)

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07:30am EST 14-Mar-00 DLJ Securities (James M. Higgins, CFA) BNI CNI CP CSX KSU  
RAILROADS: Tracking the Rails 27: Awaiting Word From the STB (1/3)

DLJ \*\*\*\*\* DONALDSON, LUFKIN & JENRETTE \*\*\*\*\* DLJ  
March 14, 2000 James M. Higgins, CFA US (212) 892-3456  
Kevin C. Meszaros US (212) 892-3192

## RAILROADS

Tracking the Rails 27: Awaiting Word From the STB  
(Part 1 of 3)

RATING: Market Perf. Change: None

## PART I of III

## THIS WEEK'S HIGHLIGHTS

- û Surface Transportation Board (STB) hearings on downstream effect of proposed Burlington Northern Santa Fe/Canadian National combination span four days and 160 presenters. We expect some changes to the merger review process short of an outright moratorium, with word from the Board coming as early as the end of this week.
- û DLJ reduces earnings estimates on heels of increase in projected fuel price.
- û We include an updated summary of various railroads' fuel hedging positions.

## VIEWPOINT

Those lonely few who still care about rail stocks spent four days of last week hearing, or hearing about, shippers, politicians, and other railroads discourse, under sponsorship of the STB, on the future of the industry as it would be affected by the proposed combination of Burlington Northern Santa Fe and Canadian National. Little else mattered, nor does it now, until we have a clearer take on the Board's thought process in handling this merger review process. That indication will determine the extent to which investors should steel themselves for what we believe is a potentially inevitable round of further industry consolidation over the next couple of years. We expect rail stocks to remain rather rudderless until these issues are resolved and will have more to say when we know the STB's leanings. In the mean time, a market performance rating appears most appropriate.

Table 1: STOCK PERFORMANCE: No Consistency Here

	S&P	BNI#	CNI	CSX@	NSC#
	Rails				
1999	-17.3%	-29.2%	1.4%	-24.4%	-35.3%
Performance					
Versus S&P	-36.9%	-48.7%	-18.1%	-43.9%	-54.8%
500					
4Q99	-7.0%	-11.8%	-13.2%	-26.0%	-16.3%
Performance					
Versus S&P	-21.6%	-26.4%	-27.7%	-40.5%	-30.9%
500					
Since YE1999	-17.8%	-19.1%	-6.4%	-30.3%	-36.9%
Versus S&P	-12.0%	-13.2%	-0.6%	-24.4%	-31.1%
500					

-- FIRST CALL --

Since	-0.4%	-1.9%	4.5%	3.6%	-7.2%
02/25/00					
Versus S&P	-3.4%	-4.9%	1.5%	0.5%	-10.2%
500					
	UNP#	WCLX*	CP	KSU	S&P500
1999	-3.2%	-21.8%	14.2%	51.7%	19.5%
Performance					
Versus S&P	-22.7%	-41.3%	-5.3%	32.2%	
500					
4Q99	-9.2%	-1.8%	-5.5%	60.5%	14.5%
Performance					
Versus S&P	-23.8%	-16.4%	-20.0%	45.9%	
500					
Since YE1999	-19.2%	-14.4%	-13.6%	14.2%	-5.8%
Versus S&P	-13.4%	-8.6%	-7.8%	20.0%	
500					
Since	-4.7%	-12.8%	-2.9%	7.7%	3.0%
02/25/00					
Versus S&P	-7.7%	-15.8%	-5.9%	4.7%	
500					

#### INVESTMENT OUTLOOK

With a distinctly negative bias, rail stocks were pretty much all over the place over the past two weeks, with the uncertainty about the regulatory review process-as embodied in last week's STB hearings-shutting out any potential for buying interest in the group. A couple of stocks made it into positive relative territory for no reason we can explain-except for perennial outperformer Kansas City Southern, whose shares are driven far more by its powerful mutual fund business than its relatively small railroad.

Looking ahead, the stocks are likely to be in limbo until the STB rules-an event some believe could come as early as this Friday-and then we'll see. As we discuss in some detail below, we believe the STB's direction in handling the BNI/CNI case will help bring some stability to financial market views of the railroads-although we cannot at this point predict exactly how they get there. If that happens, we believe railroad stocks may begin to trade more on their fundamentals and, pretty much regardless of the company, that looks to us likely to produce somewhat higher prices. Until we know more on this front, we believe that a market performance rating on the group is best.

#### OF INTEREST.

##### STB Hearings Lay Groundwork for Something

We listened attentively to the four days and 160 presenters in last week's STB hearing on the downstream impact of the proposed combination of Burlington Northern Santa Fe and Canadian National. All in all, there was less support for the combination than we expected, and the opportunity for the hearing itself to begin to frame the discussion of the industry's outlook was, correspondingly, not as great as we had hoped. It was our belief that any information was better than none, yet what we got out of the hearings was a distinct bias toward not proceeding with this merger, against a backdrop of uncertainty about how we could get there. In the following paragraphs, we summarize our comments about various parties'

-- FIRST CALL --

testimony as the days passed, and end up with our expectations for the Board's direction.

Day One: Tuesday

The testimony of the CEOs of BNI and CNI focused on the merits of their transaction within the current regulatory framework. It was our view that the entire point of the current STB hearing is to investigate how appropriate the current rules are as the railroad industry continues to consolidate. We were surprised that BNI's and CNI's testimony did not attempt to address those broader issues, and believe that their presentations shed little light on the likely outcome of these hearings. We saw an inherent inconsistency in the BNI/CNI testimony. They argued that their merger should be allowed to be consummated while other combinations are either not inevitable or should be delayed until they will be "good" mergers. BNI/CNI are, therefore, arguing that their merger should be reviewed under the current public benefits vs. public harms standards, which is a unique merger oversight framework that has evolved precisely because the railroad industry is a network business whose economics are driven by scale and density of traffic flows. The inconsistency in their testimony was that BNI and CNI essentially argued that the network characteristics of the railroad business should be considered when their merger is reviewed, but that it somehow does not apply to the economies of scale and traffic density that their competitors would need to effect if they are allowed to merge.

The net testimony of various other railroad CEOs, several members of Congress, the Departments of Agriculture, Defense and Transportation, and the STB members' comments rounded out Tuesday's hearings. None of these participants counseled anything more than having the STB proceed carefully in vetting the BNI/CNI combination, and many were simply hostile to the idea of any further railroad industry consolidation at this point. The idea of a moratorium on further railroad industry consolidations was floated more than once on Tuesday.

Day Two: Wednesday

Day Two started off with comments from various labor representatives. The unions' broad, but by no means unanimous, advice to the Board on how to proceed was to go slowly, and probably to create a very high if not insurmountable bar to the BNI/CNI and any future proposed mergers. None of that is surprising.

We were somewhat uncomfortable about one element of this labor dynamic, however. The Brotherhood of Locomotive Engineers (BLE) supported the merger, but appeared to be doing so primarily because of substantially improved (from the union's standpoint) guarantees by BNI/CNI on payments to be made to any severed employees (10 or more years of pay instead of the usual six years), guarantees about no job transfers across the US/Canada border, more favorable relocation benefits within the allowed geographic scope, and agreement by the railroads to submit all merger-related disputes to collective bargaining rather than arbitration that the unions believe is less favorable to their cause. Our obvious concern was that BNI and CNI are buying what little labor support they've been able to muster, and that there may be additional giveaways to other labor groups as discussions continue. This merger already has limited cost savings benefits to recommend it, and we are uneasy that BNI and CNI are giving away some of what little savings are already "promised" to their shareholders.

Rep. Jerrold Nadler (D-NY), representatives of intermodal companies, including UPS (UPS#), shortline railroad entities, chemical and plastics manufacturers, and logistics companies finished off Day Two. Rep. Nadler

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was concerned about the industry's poor history of delivering on promised merger benefits and wanted the STB to take a very hard look at the industry's ultimate shape if this merger is approved. The intermodal companies had mixed opinions on how the Board should proceed, with UPS recommending a very cautious approach, including a moratorium on rail mergers until 2002. In a moment of levity that appeared not to be intended, UPS' description of itself as a "captive shipper" to the railroads was, coming from a company whose market capitalization is more than that of the entire railroad industry's, the cause of a few smiles. The shortline railroad groups had mixed opinions as well, with the determining factor for support of the merger appearing to be ties with BNI or CNI; we wondered how much the potential for leverage over the shortlines by the large carriers affected the little railroads' opinions. The chemical and plastics companies, and their trade associations, didn't so much care about how the STB proceeds with this merger review but just wants somebody to inject more competition into the railroad industry. This was one group where we thought we might see some divergence between the very strident view taken by the industry trade group, the Chemical Manufacturers Association, yet all company speakers pretty much hewed to the same aggressive rhetoric decrying a lack of railroad competition. Finally, the logistics companies had mixed opinions on how to proceed, depending on the kind of service they've received in their dealings with BNI and CNI.

Continued on Part II

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-> End of Note <-

-- FIRST CALL --

07:31am EST 14-Mar-00 DLJ Securities (James M. Higgins, CFA) BNI CNI CP CSX KSU  
RAILROADS: Tracking the Rails 27: Awaiting Word From the STB (2/3)

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RAILROADS  
Tracking the Rails 27: Awaiting Word From the STB  
(Part 2 of 3)

RATING: Market Perf. Change: None

PART II of III

OF INTEREST.

STB Hearings Lay Groundwork for Something (continued)

Day Three: Thursday

Auto makers, notably General Motors (GM), electric utilities and their trade associations, and mining groups, including coal miners began Thursday's hearings. There was a striking unanimity across the day's presenters in their desire to see the pace of railroad industry consolidation slowed or halted. Increased rail competition, more attention to service, and additional study of the issue of downstream impact on the industry of the proposed BNI/CNI combination were all common themes today. The only surprise among these presentations was GM's, which at least one of the merger applicants had expected to be essentially neutral on the proposed BNI/CNI merger. GM, however, fell very much in line with the cautious tone on the subject of further industry consolidation. Later in the day, the lumber and paper industry speakers were probably more upset by this proposed rail combination than any group, bringing up, broadly so for the first time, issues related to what they characterized as unfair advantages held by Canadian producers, and wondering how they will not inevitably lose out when a Canadian railroad merges with an American carrier.

On the other hand, the several academics that testified on Thursday, including a business school professor of this writer, universally advocated the status quo in the STB's review of the BNI/CNI merger case. Their reasoning was that existing STB policies maximize long-term economic utility; minimize uncertainty for investors, employees of the applicant railroads, and other stakeholders; are more appropriate than any alternatives in an economy where change has rapidly accelerated; and are far more likely to be able to determine a meaningful outcome than a broader study of downstream implications of the combination. In our view, their logic was compelling in a perfect world. Yet the very reason these hearings were held in the first place is that the railroad industry exists in a very messy world, in which many who have the power to alter the industry's future in ways that would horrify the academics are, in fact, not so sure that "business as usual" is the correct course of action for the STB to be taking in the case.

Thursday was also a day when listening carefully to the questions and comments of the STB commissioners, especially those of Chairperson Linda Morgan, reinforced our early bias toward some looming change in the merger review process. Such language as "in striving to protect the public interest, we can't have our heads in the sand, and we are now in a very

-- FIRST CALL --

challenged period"-which is a close paraphrase of a comment by Chairperson Morgan-only added to our belief that the Board feels pressure to make some changes to the merger review process, even if it is not its first instinct.

Day Four: Friday

The last day of the STB's hearings on the downstream impact on the railroad industry's structure of the proposed BNI/CNI included testimony from representatives of state and local governments, and from agricultural groups. The opinions of the state and local governments were probably the most mixed of any single group we heard all week, although even their testimony was, overall, balanced in its split between wanting the STB to review the BNI/CNI merger application on a "business as usual" basis and wanting to delay further consolidation in the industry. Their opinions appeared more than anything to be determined by the extent to which the proposed combination will bring increased rail service, read "competition", to their communities.

The agriculture groups, including the National Grain and Feed Association and the American Farm Bureaus Federation, were almost universally unsupportive of further merger activity. Their stance echoed that of many other shippers in decrying the perceived reduction in rail competition from the string of mergers in recent years.

At the end of the week, we held on to our belief that the STB had essentially preordained that there will be changes to the regulatory review process. It perceives, we believe, that it must appear responsive to the political and shipper elements that, overwhelmingly, decried further railroad industry consolidation in these four days of hearings. The most extreme change, one that was constantly bandied about-a moratorium-is not, to our understanding, a legal option for the Board: We believe it cannot refuse an application by two railroads to merge.

On the other hand, there is more than one way to skin the proverbial cat. The Board could indicate such a strong aversion to reviewing a merger at this point-or in some other way indicate a likely delay in processing any merger application-that it institutes a de facto moratorium. The trick in that approach, as we see it, is to move to stabilize the industry's structure in such a way as to keep capital markets participants from wondering when the next shoe will drop. In other words, the STB must create some certainty about the strategic framework so as to provide a stable backdrop against which railroad fundamentals can begin to correct the discount for perceived regulatory risk the market has built into the stocks. We firmly believe the STB is aware of this issue and views it as important.

We do not know how the STB will bridge the gap between what we believe they may want to do and what they legally can do, but we have confidence that they will carefully consider the capital market implications of any changes to the merger review process. We would caution about getting too optimistic about a complete elimination of rail mergers from the investor frame of view, as we really do believe there is no magic bullet here. Yet, we expect whatever actions the STB takes to be announced within a couple of weeks and the latest, and possibly as early as the end of this week. We'll assess them when we see them and, believe they may set us up for a situation where railroads trade more on their fundamentals than they have since late last year but, in the meantime, we continue our market performance rating on the group.

DLJ Reduces Railroads' 2000 Earnings Estimates

Rising fuel prices are likely to take a toll on the earnings of all

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transportation companies, and the railroads, while less sensitive than most, are no exception. Just as we recently adopted an average price of \$25 per WTI crude barrel in forecasting 2000 earnings estimates for the airlines, we implemented the same assumption on March 13 for the railroads. That new fuel price assumption matches the high end of the \$22-25 per barrel range that DLJ's energy team adopted a couple of weeks ago, and is up from our prior forecast of \$22 per barrel. All else probably isn't equal in making this revision, however. In reducing earnings estimates for the railroads, we are not passing through the entire hit to earnings, because we expect some offset in the form of higher prices in certain commodities. We have already some evidence that price increases are sticking. The following table presents our estimate revisions for the railroads under our coverage, of which the average is 7%,

DLJ RAILROAD UNIVERSE  
Earnings Estimate Revisions

	BNI#	CNI	CSX#
DLJ 1Q00 Est.	\$0.52	\$0.64	\$0.19
Former DLJ Est.	NE	NE	NE
1Q99	\$0.50	\$0.43	\$0.36
Yr-yr Change	4%	49%	-47%
First Call Mean	\$0.55	\$0.59	\$0.17
DLJ 2000 Est.	\$2.55	\$2.80	\$2.35
Former DLJ Est.	\$2.65	\$2.85	\$2.85
1999	\$2.43	\$2.47	\$1.59
Yr-yr Change	5%	13%	48%
First Call Mean	\$2.68	\$2.89	\$2.31
	NSC#	UNP#	WCLX*
DLJ 1Q00 Est.	\$0.00	\$0.65	\$0.29
Former DLJ Est.	NE	NC	NC
1Q99	\$0.30	\$0.52	\$0.27
Yr-yr Change	-100%	25%	7%
First Call Mean	\$0.09	\$0.72	\$0.30
DLJ 2000 Est.	\$1.00	\$3.75	\$1.50
Former DLJ Est.	\$1.10	\$3.85	NC
1999	\$0.63	\$3.12	\$1.30
Yr-yr Change	59%	20%	15%
First Call Mean	\$1.05	\$3.91	\$1.50

Updating Fuel Price Hedging Positions

The following table illustrates our latest information about the fuel price hedging positions of the railroads we follow. The range is from heavily hedged at Burlington Northern Santa Fe to completely unhedged at CSX and Norfolk Southern.

DLJ RAILROAD UNIVERSE  
FUEL PRICE HEDGING POSITIONS

BNI Hedged about 40% of annual need at an average price of \$0.65 per gallon  
CNI 31% hedged for the year, evenly spread, at prices of \$19-20 per barrel

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CSX No hedges in place  
NSC No hedges in place  
UNP 10% hedged for 2000 at an average price per gallon in the  
low \$0.50s  
WCLX Hedged on no more than 30% of needs for the year

Continued on Part III

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08:27am EST 14-Mar-00 ING Barings (Douglas W. Rockel (212) 409-6121) BNI CSX C  
Outcome of STB Hearing Could Act as an Industry Catalyst

Railroad

# Outcome of STB Hearing Could Act as an Industry Catalyst

March 14, 2000

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## \* Industry Overview

\* Last week the Surface Transportation Board (STB) concluded its four-day Major Rail Consolidation Hearings in Washington, D.C. Testimony was given by many individuals connected with the railroad industry including major Class I railways, labor organizations, shortline railways, shippers and governmental representatives.

\* The overall sentiment at these hearings was, in our opinion, decidedly negative (i.e. against future mergers without a moratorium or further regulation). Many who testified, including CSX and UNP, called for a moratorium before any more rail mergers are considered in order to allow the industry to recover its service standards. Reactions from Chairwoman Linda Morgan have suggested that she is worried about the timing of the recently proposed BN/CN merger as she stated that the industry is suffering from "merger fatigue."

\* Consequently, we believe the STB will either impose a moratorium on the merger or place further regulations on future mergers. Any such action could act as a catalyst for rail stocks, which have been out of favor with investors. \* We continue to recommend the shares of Burlington Northern Santa Fe (NYSE: BNI-19 5/8), CSX Corporation (NYSE: CSX- 21 7/8), and Union Pacific (NYSE: UPS-35 1/4) among the Class I rails as Strong Buys and likewise favor the shortline operators Genesee & Wyoming, Inc. (OTC: GNWR-12 7/8) and Rail America, Inc. (OTC: RAIL-f6 19/32) or higher growth small cap investors.

## \* Hearing Highlights

Last week the Surface Transportation Board (STB) concluded its four-day Major Rail Consolidation Hearings in Washington, D.C. Although these hearings were primarily in response to the Burlington Northern Santa Fe/Canadian National Railway merger announcement, participants focused on the effects of past mergers, possible impacts of future mergers and the general structure of the rail industry. More specifically, testimony was heard from many individuals connected with the railroad industry including major Class I railways, labor organizations, shortline railways, shippers and governmental representatives.

Not surprisingly, Burlington Northern and Canadian National were in favor of the STB going forward with reviews of possible rail consolidations. Both Rob Krebs (CEO Burlington Northern) and Paul Tellier (CEO Canadian National) asked the STB to judge the proposed merger based upon its merits and not consider any potential downstream affects on the industry. Indeed, both leaders argued that their transaction was far simpler than the previous mergers that sailed through the STB approval process in that it is end-to-end in nature and does not

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require either company to assume additional debt. Meanwhile CSX, Norfolk Southern (NYSE: NSC-12 15/16), Union Pacific and Canadian Pacific (NYSE: CP-18 5/8) testified to the board that they were against any further mergers until the industry could fully recover from the service problems that were brought about by previous mergers. Although, the Kansas City Southern Railway (NYSE: KSU-85 3/16) retained its neutral stance on the proposed mergers, the company noted that if the BN/CN merger were approved they would have a competitive response. The Union Pacific Railway echoed this sentiment, noting that such actions could eventually lead to a North American rail duopoly, which has caused some in the industry to fear governmental re-regulation. Consequently, most of the class one railroads were in favor of a moratorium for future rail mergers of roughly 16 months with CSX Chairman and CEO John Snow calling for a merger free period of 3-5 years.

In contrast, the shortline railroads remained split on supporting near term mergers of the Class I railroads. Many shortlines closely mirrored the same opinion as the major railroad(s) that were closely connected with them. More specifically, the Wisconsin Central (OTC: WCLX-11 1/2), which proclaimed its support of the BN/CN combination, announced on the same day that the BNI and CNI had agreed to give the company trackage and haulage rights that would allow it expand its reach in Canada and the Upper Midwest. The American Shortline Regional Railroad Association, however, called for adoption of a "Bill of Rights" to protect its more than 400 constituents via guaranteed rates, elimination of paper barriers, non-discriminatory pricing and more favorable car-supply agreements before the STB proceeds with any further mergers.

Support for near-term mergers also appears slim among the rail labor organizations as several labor organizations called for a moratorium, noting that labor has suffered from all the previous mergers in the industry. The lone exception, however, came from the Brotherhood of Locomotive Engineers, which recently reached a 10-year agreement with the BNI and CNI. Nevertheless, all of the labor unions took the opportunity in front of the board to voice concerns over various merger related issues including "cram down" provisions and the elimination of seniority districts.

After recent rail merger decimated rail service throughout North America, restrained competition, and in some cases led to higher rates, shipping groups were, for the most part, upset over the possibility of another merger. Although reaction was split among the intermodal shippers who testified, the two largest intermodal companies in attendance, United Parcel Service and Pacer International lodged decidedly anti merger statements to the STB. Indeed, UPS, which incurred roughly \$20 million in unexpected expenses from June to December due to poor rail service, supported a moratorium until 2002. Chemical & Plastic shippers were equally indignant over poor rail service, sounding a cry for increased rail competition in favor of more mergers. While the lumber and paper shippers also cited concerns over the rail service situation, many were also cool to the prospect to foreign ownership of a major western railroad. More over, many in the U.S. lumber industry believe that the Canadian lumber industry receives unfair subsidies from the government.

While foreign ownership did not appear to bother automotive giant General Motors Corporation, poor service did as the company, which spends roughly \$1.2 billion per year for its rail service, noted that it has incurred roughly \$250 million in extra costs last year because of rail service disruptions. Not

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surprisingly, GM voiced its opposition to any further rail mergers and called for the rail industry to concentrate their efforts on improving existing service. The company noted, however, that it would be against any government re-regulation. The only other automotive manufacturer to participate in the hearings, Mazda, opted to take a neutral stance on further mergers but stated that the company believed the utmost cautions should be used by the STB in reviewing any further rail mergers. Mazda went on to add that it believed further rail mergers would lead to a further degradation to competition in an industry that is already a practicing oligopoly.

While neither the Western Coal Transportation Association or the National Mining Association called for delay in any further mergers, the two coal shipping groups both urged caution in approving future mergers with focus being placed on creating competition. Similar points were also made by the representatives from Utility companies, most of which are captive shippers. With the industry coming fresh out of recent deregulation, some utility companies hinted that open access could be a viable option to improve competition in the rail industry. In fact, one utility representative recommended that rail shippers be allowed to trade railroad capacity rights, a system that has been in place in the power industry since deregulation.

#### Investment Conclusion

Although the STB has a long-standing record of approving rail mergers (investors should note that the STB has only denied one rail merger since 1986), it appears that times may be changing. Indeed, we believe the board's decision to consider the downstream effects of future mergers and forgo the traditional "one at a time approach" speaks volumes. Despite her best efforts to remain independent, we feel that Chairwoman Morgan came into the hearings with an anti-merger sentiment as she noted in her opening statement that the rail industry was suffering from "merger fatigue." Furthermore, she was presented with an abundance of testimony to build a record that could support imposing a moratorium or tighten the regulatory requirements for any future mergers. We anticipate that the STB will react quickly on this matter, likely issuing a ruling within the next two weeks. Consequently, we believe that the rail industry is full of many buying opportunities, such as Strong Buy rated CSX, Union Pacific and Burlington Northern Santa Fe, as any ruling that is of a negative bias towards further mergers could create a catalyst for the rail stocks, which have been severely depressed since late last year over concerns that additional mergers would also create additional service failures and cost pressures.

Additional information available upon request. Stocks priced as of previous session's close.

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01:34am EST 8-Mar-00 Morgan Stanley\DW (Valentine, James J. 212-761-8015) BNI  
RAILROADS: STB DELAY COULD GIVE SLIGHT BOOST TO STOCKS P1

North America: United States of America

March 08, 2000

Industry Overview

Railroads

STB Delay Could Give Slight Boost to Stocks

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-NO BIG SURPRISES FROM DAY ONE OF STB PROCEEDINGS

Unsurprisingly, BNI and CNI argued in favor of their proposed merger, while the other railroads argued for a moratorium on rail mergers until rail service and financial woes have been solved.

-OTHER WITNESSES OFFERED CAUTION

The overwhelming response from other witnesses was for the STB to take a cautious and thoughtful approach when considering future rail consolidations.

-WE STAND BY OUR VIEW

We believe a moratorium on railroad mergers is likely to be the outcome of the March hearings, which would put the BNI-CNI merger proceeding on hold.

-STB DECISION TO DELAY MERGERS COULD BE POSITIVE

We believe a decision from the STB to delay the merger process could initially be viewed as a positive by the Street as it would remove some near-term uncertainty.

-BNI, CNI AND UNP ARE POSSIBLE TRADING PLAYS

In the event of a delay in the merger process, we believe that BNI, CNI and UNP could enjoy some near-term strength in their stocks.

-MAINTAIN NEUTRAL RATING ON THE GROUP

But unless interest rates and oil prices stop rising, it will be tough for the railroad sector to sustain a long-term rally.

KEY RATINGS

Burlington Northern Santa Fe (BNI-\$19.25)Neutral

Canadian National (CNI-\$22.50)Neutral

Canadian Pacific (CP-\$19)Outperform

CSX Corporation (CSX-\$21.25)Neutral

Kansas City Southern (KSU-\$85)Outperform

Norfolk Southern (NSC-\$13)Neutral

Union Pacific (UNP-\$36)Neutral

STB Delay Could Give Slight Boost to Stocks

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We participated in the first day of Washington hearings held by the Surface Transportation Board (STB) which focused on the future of railroad consolidations, including the currently proposed combination between Burlington Northern Santa Fe (BNI, Neutral, \$19) and Canadian National (CNI, Neutral, \$24). The first day included testimony from Senators, Representatives, government agencies, the CEOs of the Class 1 railroads, Wall Street representatives and major shipper associations. The hearings continue through March 10.

#### No Surprise from Day One

There were no big surprises from the testimony given on day one. Unsurprisingly, Rob Krebs (Chairman and CEO of BNI) and Paul Tellier (CEO of CNI) testified strongly that their proposed merger should be judged on its stand-alone merits and under the current regulatory regime. It was clear they intend to push forward with their merger application.

Generally speaking, the rest of the witnesses who testified took the opposite stance and urged that the STB move cautiously when assessing further rail consolidation. Some witnesses (Senators Rockefeller, Dorgan and the CEOs of the other major North American railroads) argued vigorously for either a complete stop to railroad mergers or, at least, a comprehensive moratorium (as much as five years) on rail mergers. Other witnesses, such as Secretary of Transportation Rodney Slater, suggested that the STB avoid imposing a moratorium on rail mergers, but rather raise the bar for determining whether a proposed transaction is in the public interest. As we would expect, shipper groups generally argued that increased competition (as a means to improve railroad service) should be incorporated into any future merger decisions from the STB.

Despite the variety of recommendations offered during Day One testimonies, it was very clear to us that, apart from Krebs' and Tellier's interest in moving forward under current regulations, the overwhelming response of witnesses was for a go-slow approach. Thus, we believe that the outcome of day one's testimonies is a confirmation of our view that it will be very difficult for the STB to approve the proposed Burlington Northern Santa Fe/Canadian National merger using the standard 16 month process (for more background see our 2/25 write-up from the Chairman Morgan lunch we hosted at our offices). In our estimation, we believe there is better than a 50% chance that the BNI-CNI merger approval process is postponed by at least a year.

#### What To Do With The Stocks?

The good news is that Chairman Linda Morgan has been very clear that the STB will issue a swift decision following the hearings. We believe this decision will come no later than March 20, 2000, which is the first day that BNI and CNI can formally file their merger application with the government. As noted above, we believe the STB's decision will likely contain some delay to the merger game. In the short-term, such a decision is likely to be viewed positively by the market as it would pre-empt what we believe is otherwise an imminent, final round of rail consolidation this spring. For short-term, nimble investors, we recommend taking a position in BNI, CNI or Union Pacific (UNP, Neutral, \$36), as they are operating smoothly at present and yet are weighed down by risk of further industry consolidation. Similarly, long-term investors who currently own these names but are looking to get out may want

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to wait for the STB's decision later in March before selling as it could be a slight positive catalyst.

With that said, we are not ready to upgrade (from Neutral) the rails as a group, as the STB's final decision may turn out to simply delay the merger process by one year which may be viewed by long-term investors as simply postponing an inevitable and risky event. Thus, we do not expect to see railroad valuations return to levels witnessed prior to the BNI-CNI merger announcement, let alone back to the more normal P/Es of three years ago. Moreover, since we do not actually know what the STB will specifically mandate in its decision following the hearings, it is impossible to assess the ultimate economic impact from potential changes to the regulatory regime. And finally, until we see reason for oil prices to begin to drop or signs that the Fed has stopped tightening, we think it will be tough for railroads to outperform the market. In summary, despite the incredibly low valuations that railroad stocks are currently experiencing, we prefer to maintain our Neutral rating as there's little to get excited about.

(PLEASE SEE PART 2)

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